Solution 28.1

The S.A. Furniture Company Limited experienced financial difficulties because, essentially, its sales growth exceeded its sustainable growth rate. As a result, cash generated by operating activities became negative in 20X0 and 20X1. A company which consistently fails to generate positive cash from operations is most likely to land up in financial difficulties.

As regards working capital an increase therein is a function of increased scale of operations (e.g. sales growth) and slacker control of stocks and debtors and creditors demanding quicker payments. Therefore the constant and significant increases in working capital are a function of growth in sales and the net trade cycle (i.e. inventory period plus accounts receivable period less accounts payable period).

With regards to dividends paid, notwithstanding the negative 'cash available from operating activities', the company paid out dividends, resulting in negative cash retained from operating activities. From the information given, it would appear that it did not have the cash income to pay such dividends and the company had to borrow to finance the payment of dividends, an extremely undesirable and dangerous policy.

Heavy use was made in 20W9 and 20X0 of preference shares and long-term loans in 20X0 to 20X2. The results of the above were that finance costs and dividends on preference shares increased a great deal and resulted in a very large loss in 20X2 and caused delisting in 20X3.

Solution 28.2

		20X3 C000s	20X4 C000s	20X5 C000s
Accounts receivable collection period	*W1*	60 days	76 days	80 days
Inventory holding period	*W2*	91 days	105 days	110 days
Accounts payable payment period	*W3*	63 days	60 days	61 days
Current ratio	*W4*	3.1	3.3	3.2
Acid test ratio	*W5*	1.6	1.6	1.6

Although the company's liquidity position, as evidenced by the current ratio and the acid test ratio, appears to be growing stronger, the ratios appear to indicate a problem with the working capital management of the company. Industry ratios would be useful to compare with the company but at first glance the company appears to have excessive funds tied up in non-interest bearing current assets.

Debtors are taking longer to pay and the provision for bad debts may need to be examined. The increase in turnover may be a result of more lenient credit terms but it may also be a result of more lenient credit controls which may result in bad debts arising.

Cash is also being tied up in inventory holdings which have been increasing substantially over the period examined. The stock should be examined to identify any obsolete or slow moving items and purchasing should be monitored to improve the efficiency of holdings.

Creditors' days have remained steady around 60 days. Where possible, efforts should be made to increase the use of this interest free funding and no early payments should be made unless adequately compensated for by settlement discounts.

Solution 28.2 continued …

Workings

W1 Accounts receivable collection period

		20X3		20X4		20X5	
Average debtors balance	X 365	16 500	X 365	25 000	X 365	29 600	X 365
Credit sales		100 000		120 000		135 000	
		= 60 days		= 76 days		= 80 days	

W2 Inventory holding period

		20X3		20X4		20X5	
Average inventory balance	X 365	18 750	X 365	26 000	X 365	30 400	X 365
Cost of sales		75 000		90 000		101 250	
		= 91 days		= 105 days		= 110 days	

W3 Accounts payable payment period

		20X3		20X4		20X5	
Average creditors balance	X 365	13 000	X 365	14 700	X 365	17 000	X 365
Cost of sales		75 000		90 000		101 250	
		= 63 days		= 60 days		= 61 days	

W4 Current ratio

	20X3	20X4	20X5
Current assets	40 250	51 000	60 000
Current liabilities	13 000	15 200	19 000
	= 3 : 1	= 3,3 : 1	= 3,2 : 1

W5 Acid test ratio

	20X3	20X4	20X5
Current assets - inventory	21 500	25 000	29 600
Current liabilities	13 000	15 200	19 000
	= 1,6 : 1	= 1,6 : 1	= 1,6 : 1

Solution 28.3

a) **Purpose of financial statement analysis**

- Financial reporting provides information about the financial position, changes in the financial position and the performance of a business entity that is useful to a wide range of users in making economic decisions.
- The users need to evaluate the financial position of a business entity and the results of its business operations, when making economic decisions. This evaluation is the overall objective of financial statement analysis.

b) **Current and quick ratios**

20X1

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{1\,290}{315} = 4.1 : 1$$

$$\text{Quick ratio} = \frac{\text{Current assets – inventory}}{\text{Current liabilities}} = \frac{1\,290 - 836}{315} = 1.4 : 1$$

20X0

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{1\,124}{281} = 4.0 : 1$$

$$\text{Quick ratio} = \frac{\text{Current assets – inventory}}{\text{Current liabilities}} = \frac{1\,124 - 715}{281} = 1.5 : 1$$

- The current ratio for both 20X0 and 20X1 are above the industry ratio, which indicates comfortable liquidity
- The quick ratio is also above the industry ratio. This also indicates a comfortable level of liquidity
- However the difference between the current and quick ratios indicates that the inventory comprises a large proportion of the current assets, which is not as liquid as accounts receivable and cash.

c) **Return on equity**

$$\text{Return on Equity} = \frac{\text{Profit for the period – preference dividend}}{\text{Average ordinary shareholders' equity}}$$

$$= \frac{51\,590 - 0}{(680 + 663)/2} = 7.7\%$$

- This ratio measures the percentage of net profit after tax and preference dividends which is available to ordinary shareholders
- This ratio is important to ordinary shareholders because it represents the return they earn on their ordinary share investment. They would compare this return to the return they could obtain from other investments.

Solution 28.3 continued …

d) **Debt to Equity ratio**

$$\text{Debt : Equity} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

20X1

$$= \frac{(225 + 430 + 315)}{(460 + 220)} = 142.6\%$$

20X0

$$= \frac{(200 + 324 + 281)}{(460 + 203)} = 121.4\%$$

- This ratio is useful in assessing the risk that the company faces by utilising debt relative to its equity. The main risk facing a company with a high debt to equity ratio is the inability to repay the debt and interest thereon. This risk could lead to the liquidation of the company.

e) **PE ratio**

20X1

$$\text{PE} = \frac{\text{MP}}{\text{EPS}} = \frac{\text{C12.00}}{\text{C0.5159}} = 23.3$$

20X0

$$\text{PE} = \frac{\text{MP}}{\text{EPS}} = \frac{\text{C30.00}}{\text{C1.0252}} = 29.3$$

- The PE ratio is an indication of the number of years earnings that investors are buying.
- A high PE ratio is usually an indication of confidence in the company and an expectation that profits will increase. It also represent future growth opportunities within a company. However, if the ratio is too high compared to the industry or market, this may indicate an overpriced share.
- A low PE ratio is usually an indication of a lack of confidence in the company and an expectation that profits will decrease.

f) **Problems and limitations of financial statement analysis**

- Sometimes the information needed to calculate ratios is not disclosed in the financial statements.
- In the interpretation of results, it is difficult to generalize about whether a particular ratio is good or bad. For example a high quick ratio may show a strong liquidity position, which is good, or an excessive amount of cash, which is bad, because cash does not bring high returns compared to other assets.
- If there are no comparative amounts, the usefulness of the analysis may be limited.

Solution 28.3 continued …

- Different accounting practices can distort ratio comparisons. For example inventory has two valuation methods: (1) first-in, first-out; (2) weighted average. Therefore two firms in the industry could use different valuation methods. (Another example would be redeemable preference shares, redeemable after a certain period)
- Companies sometimes employ creative accounting methods to make their financial statements look better to analysts.

g) **Recommendation**

- The liquidity ratios indicate a comfortable level of liquidity, even though the inventory seems a bit high

- The profitability ratios indicate a decreasing trend
  - In 20X1 the net profit percentage was 1.34% (20X0: 3%), which is way below the industry average
  - The gross profit margin has decreased to 15.5% from 16.5% in 20X0

- The solvency ratios also indicate an increase in the liabilities which would put the company at the risk of not being able to meet its commitment. The debt to equity ratio increased. There is a risk that if the company is unable to meet its commitments the ordinary shareholders will lose all their investment in the company. The company is however technically solvent.

- The return on the equity has decreased to 7.7% in 20X1 from 15.5% in 20X0. Therefore the company is generating less returns for the ordinary shareholders.

- The company's share price has gone down, thus its PE ratio has decreased. However the company's press release relating to the new anti-aging electronic device was issued after year-end, the share price does not reflect the effect of the press release.

- The new anti-aging electronic device, which has been patented, has the potential of reversing the downward trend that the company has been facing. If there is sufficient demand for the device, the company would generate more profits and thus increase the returns to the ordinary shareholders.

- More information is required to give a comprehensive recommendation. However based on the given information, MedTech Limited should go ahead and purchase a majority shareholding in Computronic Limited on the basis of the potential growth opportunities from the electronic device provided that the company receives approval from the FDA..